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C O N F I D E N T I A L SECTION 01 OF 02 CARACAS 001138

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COMMERCE FOR 4431/MAC/WH/MCAMERON
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HQ SOUTHCOM ALSO FOR POLAD

E.O. 12958: DECL: 06/08/2017
TAGS: ECON EFIN VE
SUBJECT: GO ON, TAKE THE MONEY AND RUN

REF: CARACAS 959

Classified By: Economic Counselor Andrew N. Bowen for reason 1.4(d).

¶1. (SBU) SUMMARY: Economic and political uncertainty have convinced many Venezuelans to move assets abroad. While Venezuela has long been a source of capital flight, in recent years Venezuelans have begun to move not only liquid assets out of the country, but also to "de-capitalize" their businesses and personal finances, using cheap debt finance to move money off shore. When an economic correction occurs, or if the government expropriates their property, business owners will have gotten their money out and the BRV and banks will be left holding the bag. The publication of Venezuela's first quarter balance of payments demonstrates an increasingly large outflow of funds and the future of Venezuela's domestic industrial base looks dim. END SUMMARY.

¶2. (C) In recent weeks, bankers, financial analysts, and average Venezuelans have described to econoffs their methods for de-capitalizing, or mortgaging their lives in Venezuela. While home prices are at record highs as money in the streets chases a limited supply of homes, much of this demand is driven by easy credit. The banking sector, awash in cash, has been actively promoting car and home loans to an increasing array of borrowers. Banks have also begun offering "reverse mortgages," or home equity loans, that allow homeowners to take equity out by borrowing against the homes they already own. Contacts have described to econoffs the common tactic now for Venezuelans to obtain home equity loans and then use the parallel market to move the borrowed money into dollars and offshore. Given that mortgages tend to be at or below the rate of inflation (which has been 19.5 percent for the past 12 months), homeowners rarely have trouble paying the monthly bill. In addition, given the almost universal belief that Venezuela will (eventually) devalue the currency (probably sometime in 2008), they expect to be able to pay off the mortgage with fewer dollars than it cost.

¶3. (C) Similar to homeowners, businessmen in Venezuela have been borrowing on their assets (factories, inventories, etc.) and taking the proceeds out of the country. The theory is that they can make interest payments from current revenue and, should the economy ever tank or should the government attempt to expropriate their property, they can hand the BRV the keys, along with all of the debt.

¶4. (C) A representative of a major western bank in Venezuela described to econoffs their most popular product. The bank created a structured note based on dollar or Euro-denominated assets and priced in bolivars. The business owner purchases the product for bolivars (perhaps with borrowed money) and books it as an investment. Since the note is a proxy for hard currency assets offshore, he has essentially moved money out of the country. Essentially a parallel market transaction, this instrument has the benefit of not increasing the firm's liabilities as it remains an investment on the books, rather than a loan from a bank.

¶5. (C) Banks are permitted to hold up to 30 percent of equity in foreign currency, but many have gotten around this restriction. The President of Banco Canarias (STRICTLY PROTECT) described to econoffs their preferred system. They begin by selling their client a structured note in foreign currency issued by a U.S. investment bank. The note appears in the client's Venezuelan account, but is held abroad. It does not fall under the 30 percent rule because it is treated as the client's personal investment. This instrument protects the client from inflation and devaluation and also protects the bank as they can seize the holding in the event that the client defaults or declares bankruptcy in Venezuela.

¶6. (C) Foreign banks or those with foreign holdings can also move capital out via dividends, an especially lucrative business given their ability to obtain dollars from the Commission for the Administration of Official Exchange (CADIVI) at the overvalued official rate (Bs. 2150/dollar). Econoffs have heard that Venezuela's largest bank, Banco de Venezuela (owned by Spanish conglomerate Santander) has been especially active in moving money offshore since rumors started circulating that the government was interested in

expropriating or buying out the Spanish to merge the bank with the state-owned Treasury Bank. By repatriating profits and moving equity out via bonds, structured notes, and the parallel market, Santander can limit its exposure to Venezuela, while at the same time continuing to reap profits from the local boom in financial services.

¶7. (U) Capital flight contributed to Venezuela's USD 9.3 billion capital account deficit for the first quarter of 2007, which represented a 55.5 percent decrease from the USD 6 billion deficit during the first quarter of 2006. The capital account is the net result of public and private investment flowing in and out of the country. Coupled with the USD 3.7 current account surplus (itself having decreased by 47.7 percent year on year), this led to a drop in foreign exchange reserves of USD 5.6 billion (reftel).

¶8. (SBU) Firms are also increasingly shutting down production to focus on imports, as the overvalued exchange rate and market inefficiencies (from labor laws, to currency control regulations, to tax policy) make it far more profitable to import goods rather than produce them locally. This has led to a steady and significant decline in Venezuela's industrial base (despite economic growth in excess of 10 percent during the past three years) and led to an increasing reliance on oil sales to fund the country's spending habit (septel).

¶9. (C) COMMENT: The difficulty of measuring capital flight is compounded in Venezuela by the unregulated parallel market, which is the main method by which individuals and firms move money out of the country, given the stringent currency control regime. Anecdotal and statistical evidence strongly points to this growing trend. The decisions taken by individuals and businesses demonstrate their lack of confidence in the political and macroeconomic outlook and their well-honed survival instincts. While it makes sense to get one's money out of Venezuela, the cumulative effect is negative by removing money potentially used for investment and hollowing out a system to the point it may someday

collapse. END COMMENT.

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